

Staff Summary Report



Council Meeting Date: 08/14/08

Agenda Item Number: ____

SUBJECT: This is the second public hearing to amend Chapter 16 of the Tempe City Code relating to License, Privilege and Excise Taxes.

DOCUMENT NAME: 20080814cacc01 **TCC CH 16 - LICENSES, TAXATION & MISC BUS REGS, ETC. (0503-16)** Ordinance No. 2008.26

SUPPORTING DOCS: No.

COMMENTS: These proposed changes apply the modifications adopted by the Municipal Tax Code Commission to Tempe's Tax Code.

PREPARED BY: Phil Falcosky, Tax Audit Supervisor (350-8685)

REVIEWED BY: Jerry Hart, Financial Services Manager (350-8505)

LEGAL REVIEW BY: Dave Park, Assistant City Attorney (350-8907)

FISCAL NOTE: Implementation of the proposed changes would have resulted in an estimated decrease in privilege tax revenues of less than \$10,000 in each of the last two fiscal years.

RECOMMENDATION: Adoption of Ordinance No. 2008.26

ADDITIONAL INFO: Following each legislative session Arizona cities and towns, through the Unified Audit Committee, review new State laws to determine those areas of the Model City Tax Code that require adjustment to maintain conformity with State law. This committee meets with taxpayer advocates and business representatives to draft tax code changes, which are then forwarded to the Municipal Tax Code Commission for approval. Once the Commission approves the changes to the Model code, they are presented to each city council for adoption.

Summary

Proposed Model City Tax Code Changes

On February 8, 2008, the Municipal Tax Code Commission approved three changes to conform the Model City Tax Code to the Arizona Revised Statutes (A.R.S.). Changes included in this package are an exemption for Solar Energy Devices; an exemption for Architectural and Engineering Fees included in a construction contract; and a clarification to the definition of “Out-of-State Sale.” All of the changes apply prospectively, with an effective date of July 1, 2008. Accordingly, there are no related refunds anticipated with these changes.

Solar Energy Devices

In 2005, the Legislature approved a privilege tax exemption for “Solar Energy Devices,” with the hope that exemption would spur increased deployment of such devices, reducing the demand for electricity throughout the State. These changes bring the City code into conformity with State statute, allowing a new exemption for the sale or provision and installation of “Solar Energy Devices” under the Retail and Construction Contracting classifications. The exemption includes devices that provide passive day lighting while restricting heat transfer, devices that generate electrical power by capturing solar energy or wind power, and also passive heat storage systems, such as the use of a Trombe wall in construction. Specific tax code changes are as follows:

- **Section 16-100:** Definitions added for “Solar Daylighting” and “Solar Energy Device.” The new language is identical to A.R.S. 42-5001(14) & (15).
- **Sections 16-415(b)(11), 16-416(c)(2)(C), and 16-417(c)(2)(C):** New subsections are added to create the deduction for Solar Energy Devices under the Contracting classifications, with a sunset date of January 1, 2011 included. The new language is identical to A.R.S. 42-5075(B)(14).
- **Section 16-465(II):** New subsection is added to create the deduction for sales of Solar Energy Devices under the Retail classification – no sunset date in this category. The new language is identical to A.R.S. 42-5061(N).

Architectural and Engineering Fees

These changes bring the City code into conformity with State statute, allowing a new exclusion for gross income related to the “direct costs” of architectural and engineering services included in a construction contract. Although “direct costs” are not clearly defined in statute, there have been cases that limit qualifying costs, and the Department of Revenue is preparing guidance on this issue that will also apply to the cities. This change is a simplification for the construction industry, where many contractors now provide both design and construction services for their clients. Under the existing code, exempting the design phase of such transactions is accomplished through the use of separate contracts and legal entities. This change will allow these firms to include all services in a single contract. Specific tax code changes are as follows:

- **Sections 16-415(a)(4), 16-416(b)(5), and 16-417(b):** New subsections are added to create the exclusion of gross income related “direct costs” of architectural and engineering services. The new language is identical to A.R.S. 42-5075(J).

“Out-of-State Sale” (OSS) Definition

For some time, taxpayer advocates have requested the removal of the “non-resident” requirement from this definition, on the basis that it may violate constitutional protections against the taxation of interstate commerce. One reason for keeping this clause related to cities that had adopted Model Option #1. MO #1 allowed an OSS exemption without requiring the order to be placed from outside the State. This effectively exempted sales to tourists and other “non-residents,” even when the sales occurred entirely in the city. After lengthy debate, all affected cities agreed to eliminate Model Option #1, and also join the other cities and towns in removing the “non-resident” clause. As Tempe did not adopt MO #1, the change has no effect on Tempe.

- **Section 16-100, “Out-of-State Sale”:** The change eliminates subsection (2), which required the sale must be to a “non-resident” to qualify for the exemption.

FINANCIAL IMPLICATIONS: Although preliminary data provided by the Department of Revenue indicates that very few taxpayers have taken advantage of the Solar Energy Device deduction so far, it is anticipated that this activity will expand in the future. ADOR’s claimed deduction estimates were loosely allocated based on population, so determining how much of this activity actually occurred in the City during the period is extremely difficult. However, even using the high end of the estimates, it is unlikely that this exemption would have resulted in a reduction of Contracting and Retail revenues greater than \$10,000 during each of the past two years, had the deduction been in place during that period. This exemption may also have an adverse collateral impact on revenues from the Utilities classification at some point in the future. However, at this time there are too few devices in place that can efficiently replace traditional electrical generation to have any significant impact.

The exclusion for Architectural and Engineering Fees is not expected to have any impact on revenue. This change merely simplifies practices of the construction industry, by eliminating the need to segregate such fees from the remainder of the firm’s construction activity. It is presumed that all current activity that qualifies for exclusion is likely being reported as an exempt professional service provided by an architectural/engineering firm. We are not aware of any firm that is currently paying tax to the City on such fees.

Changing the definition of “Out-of-State Sale” will have no impact on revenue.

ORDINANCE NO. 2008.26

AN ORDINANCE OF THE CITY COUNCIL OF THE CITY OF TEMPE, ARIZONA, AMENDING CHAPTER 16 OF THE TEMPE CITY CODE, RELATING TO LICENSE, PRIVILEGE AND EXCISE TAXES BY AMENDING SECTIONS 16-100, 16-415, 16-416, 16-417 AND 16-465.

BE IT ORDAINED BY THE CITY COUNCIL OF THE CITY OF TEMPE, ARIZONA, as follows:

Section 1. That Section 16-100 of the Tax Code of the City of Tempe is amended as to the following definitions:

Sec. 16-100. General definitions.

Out-of-state sale means the sale of tangible personal property and job printing if all of the following occur:

- (1) The order is placed from without the State of Arizona; and
- ~~(2) The order is placed by other than a resident of the State to be determined in a manner similar to "resides within the City"; and~~
- (3) The property is delivered to the buyer at a location outside the State; and
- (4) The property is purchased for use outside the State.

SOLAR DAYLIGHTING MEANS A DEVICE THAT IS SPECIFICALLY DESIGNED TO CAPTURE AND REDIRECT THE VISIBLE PORTION OF THE SOLAR BEAM, WHILE CONTROLLING THE INFRARED PORTION, FOR USE IN ILLUMINATING INTERIOR BUILDING SPACES IN LIEU OF ARTIFICIAL LIGHTING.

SOLAR ENERGY DEVICE MEANS A SYSTEM OR SERIES OF MECHANISMS DESIGNED PRIMARILY TO PROVIDE HEATING, TO PROVIDE COOLING, TO PRODUCE ELECTRICAL POWER, TO PRODUCE MECHANICAL POWER, TO PROVIDE SOLAR DAYLIGHTING OR TO PROVIDE ANY COMBINATION OF THE FOREGOING BY MEANS OF COLLECTING AND TRANSFERRING SOLAR GENERATED ENERGY INTO SUCH USES EITHER BY ACTIVE OR PASSIVE MEANS, INCLUDING WIND GENERATOR SYSTEMS THAT PRODUCE ELECTRICITY. SOLAR ENERGY SYSTEMS MAY ALSO HAVE THE CAPABILITY OF STORING SOLAR ENERGY FOR FUTURE USE. PASSIVE SYSTEMS SHALL CLEARLY BE DESIGNED AS A SOLAR ENERGY DEVICE, SUCH AS A TROMBE WALL, AND NOT MERELY AS A PART OF A NORMAL STRUCTURE, SUCH AS A WINDOW.

Section 2. That Section 16-415(a) and (b) of the Tax Code of the City of Tempe is amended to read:

Sec. 16-415. Construction contracting—Construction contractors.

(a) The tax rate shall be at an amount equal to one and eight-tenths percent (1.8%) of the gross income from the business upon every construction contractor engaging or continuing in the business activity of construction contracting within the City.

- (1) However, gross income from construction contracting shall not include charges related to groundwater measuring devices required by A.R.S. Section 45-604.
- (2) Reserved.
- (3) Gross income from construction contracting shall not include gross income from the sale of manufactured buildings taxable under Section 16-427.
- (4) FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008, THE PORTION OF GROSS PROCEEDS OF SALES OR GROSS INCOME ATTRIBUTABLE TO THE ACTUAL DIRECT COSTS OF PROVIDING ARCHITECTURAL OR ENGINEERING SERVICES THAT ARE INCORPORATED IN A CONTRACT IS NOT SUBJECT TO TAX UNDER THIS SECTION. FOR THE PURPOSES OF THIS SUBSECTION, "DIRECT COSTS" MEANS THE PORTION OF THE ACTUAL COSTS THAT ARE DIRECTLY EXPENDED IN PROVIDING ARCHITECTURAL OR ENGINEERING SERVICES.

(b) *Deductions and exemptions.*

....

- (11) FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008 AND ENDING BEFORE JANUARY 1, 2011, THE GROSS PROCEEDS OF SALES OR GROSS INCOME DERIVED FROM A CONTRACT TO PROVIDE AND INSTALL A SOLAR ENERGY DEVICE. THE CONTRACTOR SHALL REGISTER WITH THE DEPARTMENT OF REVENUE AS A SOLAR ENERGY CONTRACTOR. BY REGISTERING, THE CONTRACTOR ACKNOWLEDGES THAT IT WILL MAKE ITS BOOKS AND RECORDS RELATING TO SALES OF SOLAR ENERGY DEVICES AVAILABLE TO THE DEPARTMENT OF REVENUE AND THE CITY, AS APPLICABLE, FOR EXAMINATION.

Section 3. That Section 16-416(b) and (c)(2) of the Tax Code of the City of Tempe is amended to read:

Sec. 16-416. Construction contracting—Speculative builders.

(b) *Exclusions:*

....

- (5) FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008, THE PORTION OF GROSS PROCEEDS OF SALES OR GROSS INCOME ATTRIBUTABLE TO THE ACTUAL DIRECT COSTS OF PROVIDING ARCHITECTURAL OR ENGINEERING SERVICES THAT ARE INCORPORATED IN A CONTRACT IS NOT SUBJECT TO TAX UNDER THIS SECTION. FOR PURPOSES OF THIS SUBSECTION, "DIRECT COSTS" MEANS THE PORTION OF THE ACTUAL COSTS THAT ARE DIRECTLY EXPENDED IN PROVIDING ARCHITECTURAL OR ENGINEERING SERVICES.

(c) Tax liability for speculative builders occurs at close of escrow or transfer of title, whichever occurs earlier, and is subject to the following provisions relating to exemptions, deductions and tax credits:

....

(2) *Deductions.*

....

- (C) FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008 AND ENDING BEFORE JANUARY 1, 2011, THE GROSS PROCEEDS OF SALES OR GROSS INCOME DERIVED FROM A CONTRACT TO PROVIDE AND INSTALL A SOLAR ENERGY DEVICE. THE CONTRACTOR SHALL REGISTER WITH THE DEPARTMENT OF REVENUE AS A SOLAR ENERGY CONTRACTOR. BY REGISTERING, THE CONTRACTOR ACKNOWLEDGES THAT IT WILL MAKE ITS BOOKS AND RECORDS RELATING TO SALES OF SOLAR ENERGY DEVICES AVAILABLE TO THE DEPARTMENT OF REVENUE AND THE CITY, AS APPLICABLE, FOR EXAMINATION.

Section 4. That Section 16-417 of the Tax Code of the City of Tempe is amended to read:

Sec. 16-417. Construction contracting—Owner-builders who are not speculative builders.

(a) At the expiration of twenty-four (24) months after improvement to the property is substantially complete, the tax liability for an owner-builder who is not a speculative builder shall be at an amount equal to one and eight-tenths percent (1.8%) of:

- (1) The gross income from the activity of construction contracting upon the real property in question which was realized by those construction contractors to whom the owner-builder provided written declaration that they were not responsible for the taxes as prescribed in subsection 16-415(c)(2); and
- (2) The purchase of tangible personal property for incorporation into any improvement to real property, computed on the sales price.

(B) FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008, THE PORTION OF GROSS PROCEEDS OF SALES OR GROSS INCOME ATTRIBUTABLE TO THE ACTUAL DIRECT COSTS OF PROVIDING ARCHITECTURAL OR ENGINEERING SERVICES THAT ARE INCORPORATED IN A CONTRACT IS NOT SUBJECT TO TAX UNDER THIS SECTION. FOR PURPOSES OF THIS SUBSECTION, "DIRECT COSTS" MEANS THE PORTION OF THE ACTUAL COSTS THAT ARE DIRECTLY EXPENDED IN PROVIDING ARCHITECTURAL OR ENGINEERING SERVICES.

(~~B~~ C) The tax liability of this Section is subject to the following provisions relating to exemptions, deductions and tax credits:

(1) *Exemptions.*

- (A) The gross proceeds of sales or gross income attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from or deductible from Privilege or Use Tax under:

- (i) Section 16-465, subsections (g) and (p)
- (ii) Section 16-660, subsections (g) and (p)

shall be exempt or deductible, respectively, from the tax imposed by this Section.

- (B) The gross proceeds of sales or gross income received from a contract for the construction of an environmentally controlled facility for the raising of poultry for the production of eggs and the sorting, or cooling and packaging of eggs shall be exempt from the tax imposed under this Section.

- (C) The gross proceeds of sales or gross income that is derived from the installation, assembly, repair or maintenance of clean rooms that are deducted from the tax base of the retail classification pursuant to Section 16-465, subsection (g) shall be exempt from the tax imposed under this Section.
- (D) The gross proceeds of sales or gross income that is derived from a contract entered into with a person who is engaged in the commercial production of livestock, livestock products or agricultural, horticultural, viticultural or floricultural crops or products in this State for the construction, alteration, repair, improvement, movement, wrecking or demolition or addition to or subtraction from any building, highway, road, excavation, manufactured building or other structure, project, development or improvement used directly and primarily to prevent, monitor, control or reduce air, water or land pollution shall be exempt from the tax imposed under this Section.
- (E) Development or impact fees included in a construction or development contract for payment to the state or local government to offset governmental costs of providing public infrastructure, public safety and other public services to a development.

(2) *Deductions.*

- (A) All amounts subject to the tax shall be allowed a deduction in the amount of thirty-five percent (35%).
- (B) The gross proceeds of sales or gross income that is derived from a contract entered into for the installation, assembly, repair or maintenance of income-producing capital equipment, as defined in Section 16-110, that is deducted from the retail classification pursuant to Section 16-465 (g), that does not become a permanent attachment to a building, highway, road, railroad, excavation or manufactured building or other structure, project, development or improvement shall be exempt from the tax imposed by this Section. If the ownership of the realty is separate from the ownership of the income-producing capital equipment, the determination as to permanent attachment shall be made as if the ownership was the same. The deduction provided in this paragraph does not include gross proceeds of sales or gross income from that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of the income-producing capital equipment. For purposes of this paragraph, "permanent attachment" means at least one of the following:
 - (i) To be incorporated into real property.
 - (ii) To become so affixed to real property that it becomes part of the real property.

(iii) To be so attached to real property that removal would cause substantial damage to the real property from which it is removed.

(C) FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008 AND ENDING BEFORE JANUARY 1, 2011, THE GROSS PROCEEDS OF SALES OR GROSS INCOME DERIVED FROM A CONTRACT TO PROVIDE AND INSTALL A SOLAR ENERGY DEVICE. THE CONTRACTOR SHALL REGISTER WITH THE DEPARTMENT OF REVENUE AS A SOLAR ENERGY CONTRACTOR. BY REGISTERING, THE CONTRACTOR ACKNOWLEDGES THAT IT WILL MAKE ITS BOOKS AND RECORDS RELATING TO SALES OF SOLAR ENERGY DEVICES AVAILABLE TO THE DEPARTMENT OF REVENUE AND THE CITY, AS APPLICABLE, FOR EXAMINATION.

(3) *Tax Credits.*

The following tax credits are available to owner-builders and speculative builders, not to exceed the tax liability against which such credits apply, provided such credits are documented to the satisfaction of the Tax Collector.

- (A) A tax credit equal to the amount of City Privilege or Use Tax, or the equivalent excise tax, paid directly to a taxing jurisdiction or as a separately itemized charge paid directly to the vendor with respect to the tangible personal property incorporated into the said structure or improvement to real property undertaken by the owner-builder or speculative builder.
- (B) A tax credit equal to the amount of Privilege Taxes paid to this City, or charge separately to the speculative builder, by a construction contractor, on the gross income derived by said person from the construction of any improvement to the real property.
- (C) No credits provided herein may be claimed until such time that the gross income against which said credits apply is reported.

(D) The limitation period for the assessment of taxes imposed by this Section is measured based upon when such liability is reportable, that is, in the reporting period that encompasses the twenty-fifth (25th) month after said unit or project was substantially complete. Interest and penalties, as provided in Section 16-540, will be based on reportable date.

(E) Reserved.

Section 5. That Section 16-465 of the Tax Code of the City of Tempe is amended to read:

Sec. 16-465. Retail sales—Exemptions.

Income derived from the following sources is exempt from the tax imposed by Section 16-460:

....

(LL) SALES OF SOLAR ENERGY DEVICES, FOR TAXABLE PERIODS BEGINNING FROM AND AFTER JULY 1, 2008. THE RETAILER SHALL REGISTER WITH THE DEPARTMENT OF REVENUE AS A SOLAR ENERGY RETAILER. BY REGISTERING, THE RETAILER ACKNOWLEDGES THAT IT WILL MAKE ITS BOOKS AND RECORDS RELATING TO SALES OF SOLAR ENERGY DEVICES AVAILABLE TO THE DEPARTMENT OF REVENUE AND CITY, AS APPLICABLE, FOR EXAMINATION.

Section 6. Pursuant to City Charter, Section 2.12, ordinances are effective thirty (30) days after adoption.

PASSED AND ADOPTED BY THE CITY COUNCIL OF THE CITY OF TEMPE, ARIZONA, this _____ day of _____, 2008.

MAYOR

ATTEST:

City Clerk

APPROVED AS TO FORM:

City Attorney